By Richard Rubin, CQ Staff

Here's a fiscal riddle: What's almost as big as all the money appropriated each year by Congress, more significant for the trajectory of the federal debt than the Bush tax cuts and barely gets noticed at all? It's the more than $1 trillion a year in spending done through the tax code, a collection of mostly obscure provisions that threatens to devour the federal budget.

From the deduction for home mortgage interest payments, to special tax breaks for racetrack owners and purchasers of plug-in hybrid cars, Congress has punched hundreds of expensive holes in the government's tax base. Decades of accumulated decisions have turned the Internal Revenue Code into a multipurpose policy tool while undermining its ability to perform its most basic function: generating money to pay Washington's bills.

The tax discussion that is coming this fall perfectly illustrates the blinkered approach that dominates in Congress when it comes to scrutinizing what policy wonks call "tax expenditures." When lawmakers return in a week from their summer recess, they are poised to start debating the merits of raising income tax rates on the top 3 percent of taxpayers. That's a necessary fight because most of the tax cuts enacted in 2001 and 2003 are set to expire at the end of this year, and failure to act would bump up tax rates on almost everyone. And it's critical because of the potential economic and political effects of any change in law and policy.

This fall's debate, however, won't begin to address what many experts and politicians say is the larger problem: the inefficiencies, economic distortions and budgetary blindness caused by the current tax system. Advocates from opposite ends of the ideological spectrum — including Reagan economist Martin Feldstein and House Minority Leader John A. Boehner of Ohio on the right and the Center for American Progress and Texas Democrat Lloyd Doggett on the left — want to change the way politicians think and talk about tax policy. Their argument is that as long as lawmakers and the public believe there is a hard and fast line between "taxes" and "spending," they will never pay sufficient attention to tax expenditures, which blur that boundary, add to government borrowing and escape tough scrutiny.

"With a national debt that is already too big and scheduled to get bigger, I believe even those who never met a tax break they didn't like will eventually be forced to acknowledge that this spending through the tax code cannot go unchecked any longer," says Doggett, a senior member of the House Ways and Means Committee.

Changing the terms of the debate over spending through the tax code is particularly urgent now, they say, as the federal debt swells from emergency spending programs and declining revenue. President Obama's bipartisan fiscal commission is exploring limits on tax expenditures as a way to hold down the rise in borrowing, and recommendations to do so are expected to be part of the commission's post-election report. Democratic lawmakers, in particular, are starting to call for more frequent and more thorough analyses of targeted tax breaks.

Still, in spite of the attention that the fiscal commission might bring to this issue, lawmakers have plenty of practical reasons to avoid the discussion. Attempts to teach politicians and the public new ways to think about taxes and spending will run headlong into the same powerful factors that have repeatedly prevented a detailed dissection of the tax code since its last overhaul a quarter-century ago. Big, popular tax breaks such as the mortgage interest deduction benefit from their status as entrenched middle-class entitlements. Smaller items in the corporate tax code are immune, thanks to parochialism fueled by lobbying campaigns and lawmakers with hometown interests. Some on the right reflexively oppose anything that can be labeled a tax increase. Together, those forces forestall most serious discussions about curtailing tax breaks.

Yet, it's hard to dismiss the central absurdity of a political system that applies different standards to economically equivalent programs just because one is labeled a "tax cut" and the other is called "spending."

Consider the following hypothetical example: Say a member of Congress were to propose a new program through the Department of Health and Human Services to make grants to charities chosen and supported by individuals. The grant program would be open, however, only to taxpayers who spent above a set amount to finance their houses or pay state taxes, or on other specified but unrelated items. The size of those grants would rise as an individual's income increased, so that the government would provide bigger subsidies to the favored charities of the well-off and smaller subsidies to those preferred by middle- and working-class taxpayers. The new program would cost about $46 billion a year, roughly equal to the entire budget of the Education Department, but it wouldn't be subject to annual appropriations.

The idea sounds both silly and wildly impractical, and any lawmaker who proposed it would draw scoffs from both Democrats and Republicans, but that's almost exactly how the permanent itemized tax deduction for charitable contributions operates. Converting it into equivalent spending lays bare the choices embedded in a sacrosanct policy that never has to be evaluated or reviewed.

Given the economic cost of raising tax rates and the demographic and political difficulty of imposing spending cuts on social programs, experts on both the left and the right are beginning to understand that taking a hard look at tax expenditures could be a particularly effective way to clean up the cluttered tax code and contain the long-term debt.

There’s even room for a tantalizing bipartisan compromise — once Democrats realize that tax expenditures are regressive and once Republicans realize they are spending programs in disguise.

A Testament to Creativity

Tax expenditures have entered and exited the tax code over the decades, purged in occasional waves of simplification and reintroduced by lawmakers looking to help an interest group, boost an industry or soften the blow of a recession. Defined as exceptions to normal income tax rules, lists of them, compiled by the congressional Joint Committee on Taxation and the Office of Management and Budget, number in the hundreds. Together, they now equal about $1.2 trillion a year in forgone revenue — almost as much as the entire $1.4 trillion discretionary federal budget — with their benefits flowing to groups as disparate as film producers, timber growers and people paying off college loans.

The biggest and most recent effort to limit tax expenditures was in 1986, when President Ronald Reagan joined with a Democratic-led House and a Republican-led Senate to broaden the tax base and greatly reduce tax rates in a comprehensive rewrite of the code.

That is still the model for many proponents of overhauling tax law, including Sens. Ron Wyden of Oregon, a Democrat, and Judd Gregg of New Hampshire, a Republican, who introduced a bill on the subject earlier this year. But they face obstacles that their predecessors didn’t. The 1986 law increased the total amount of tax levied on corporations to allow for a reduction in overall payments by individuals. That would be difficult in a new examination of tax benefits for businesses, because U.S.-based multinational corporations rightly point out that they face a much higher statutory tax rate than their overseas competitors. Companies intend to use that argument to make a case for devoting revenue raised from eliminating corporate tax breaks to reducing the corporate rate, and they would probably fight fiercely against attempts to reduce tax breaks and broaden the base without a corresponding rate cut.

Second, the 1986 law was based on a premise of “revenue neutrality,” which constrained lawmakers by forcing them to find offsets — largely from tax expenditures — for rate reductions. But now, with the enormous federal debt hanging over every decision, lawmakers are under pressure to enact a “revenue-positive” tax law, which can easily lose the label of “reform” and attract the label of “tax increase.”

Would-be reformers also face a tax code with much more intricately embedded spending provisions, created by lawmakers who have grown more skillful at developing methods for using the tax code as an appropriations tool.

Ed Kleinbard, who was a lawyer in New York before becoming the chief of staff of the Joint Tax Committee in 2007, said that when he arrived in Washington he was surprised at the attention devoted to creative tax engineering. “I did not appreciate how narrow the focus of members was, how little time was spent thinking about larger consequences and patterns, and how much time is spent negotiating the tax expenditure of the minute,” said Kleinbard, who left the committee in 2009 and is now a law professor at the University of Southern California.

For example, consider “qualified forestry conservation bonds.” The 2008 farm law created $500 million in these new securities to purchase and preserve forest land, and a government subsidy was provided in the form of tax credits for investors who bought the bonds. But the law contained special conditions that limited its applicability, including requirements that the land in question be adjacent to land already owned by the Forest Service, that it contain at least 40,000 acres and that it be subject to a fish conservation plan approved by the Fish and Wildlife Service. The law also included a unique cash-out option that allowed an organization receiving an allotment of the bonds to forgo issuing them and instead receive half the amount as a refund for taxes paid, even if the organization didn’t actually owe any tax in the first place.

All of that language amounted to a one-time $250 million earmark for a single conservation project in Montana, home to the provision’s author, Senate Finance Chairman Max Baucus. The money went to The Nature Conservancy, which used it to purchase 112,000 acres of land from the Plum Creek Timber Company and then donate it to the Forest Service. What’s more, the deal doesn't even end logging on the land. Under agreements negotiated by Plum Creek, The Nature Conservancy and the Forest Service, the tract is still open to some logging.

In a similar but less intricate maneuver, lawmakers have turned to the tax code to target direct financial help to businesses facing tough economic times. For instance, a company that's losing money can't use traditional deductions or credits as readily as one that's making money, because of limits on how losses and credits accumulated one year can be applied against past or future profits. Enter the "grant in lieu of credit." Without terminating a tax credit program or changing the rules for money-making companies, Congress has allowed tax credits to be converted into cash grants.

In the 2009 stimulus law, Congress let states take cash instead of their typical annual allocations of low-income housing tax credits, which are then passed on to housing developers. Money is thus transferred from Washington to private companies and because it comes as a new adaptation of a tax credit, it became law with much less scrutiny than it might have attracted had it been an up-front appropriation.

Tax writers also have begun to shift to capped and allocated tax credits such as the "48C" program for clean energy manufacturers that was created by the stimulus law. It requires companies interested in the benefit to apply to the Energy and Treasury departments, which then award credits against taxes owed based on specific criteria and subject to a limit on the total available. The administration is now seeking to raise the limit to provide another round of awards under the program. That's very different from a typical credit that companies claim by performing a specified activity and claiming the benefit on their tax returns.

On one hand, analysts say, capped and allocated tax credits contain features that are uncommon in the tax world and avoid some of the flaws of traditional tax expenditures. The government releases lists of the companies receiving the credits, in contrast with the normal privacy rules that make it difficult, for example, to tell how much any one company gets from the research and development tax credit. Also, limits on the cost to the government create an automatic review before more money can be spent, compared with tax programs that continue indefinitely.

On the other hand, however, a capped and allocated credit up for periodic review looks almost exactly like a spending program — just one that isn't called spending and doesn't go through the Appropriations committees.

“Members of Congress like to control tax policy,” said Gerald Prante, senior economist at the Tax Foundation. “Despite it being a way to raise revenue, it’s also a way to manipulate the economy.”

Hidden Costs, Obscure Benefits

The recent burst of targeted tax expenditures and the longevity of scores of others make it difficult for lawmakers to have a comprehensive discussion about the real cost of government. In the view of many economists, tax expenditures directly distort economic decision-making. Beyond that, the lack of clear information about the programs’ benefits and drawbacks has the indirect effect of distorting political decision-making.

Republicans on the president’s fiscal commission have talked about setting targets for the size of government, measured by revenue and spending as a share of gross domestic product. Commission member Paul D. Ryan, a Wisconsin Republican and member of the House Ways and Means Committee, has proposed holding revenue at about 19 percent of the economy, roughly the average for the post-World War II period. Commission co-chairman Erskine Bowles, a Democrat, has floated a target of 21 percent of GDP for spending, similarly close to the average of the past half-century. Both numbers have become controversial because they each represent a vision about the size and role of government.

Regardless of which number, if either, might be right from a philosophical standpoint, tax expenditures render such calculations virtually meaningless, because they mask the true impact of the government on the economy.

If the home mortgage interest deduction, which totaled $92 billion this year, were converted into an identical cash grant awarded by the Department of Housing and Urban Development, taxes would increase and spending would rise — even though nothing other than paperwork would have changed for either the government or individuals.

Similarly, if a spending program such as an office-supplies purchase at the General Services Administration were turned into a tax credit for the winning contractor, taxes and spending would both decline — again, without a real-world change.

Douglas Holtz-Eakin, a former director of the Congressional Budget Office (CBO) who now leads the American Action Forum, a center-right think tank, argues that lawmakers must begin to accept that eliminating tax expenditures that are similar to spending programs isn't the same thing as a tax increase. His argument runs contrary to the approach of many Republicans, who often defend targeted tax cuts and oppose targeted spending programs with equal fervor. That more typical GOP view "is mistaken, because the right way to think about the scale of government is the degree to which it intrudes on the ability of private citizens," Holtz-Eakin said. Thinking about tax cuts as spending programs doesn't make government bigger, it just makes it easier to measure, he said.

Not all tax expenditures closely resemble spending, nor could they all easily be converted into grants or contracts. Moreover, many experts say some special provisions, such as the earned income tax credit, accomplish their goals most efficiently when delivered through the tax code because they are based on income information the IRS already has.

But there are many items in the large pool of tax expenditures — from the special treatment afforded to capital gains on the sale of coal royalties to special rules for employee stock ownership plans — that have direct effects on the economy that may be unintended and whose public policy benefits are difficult to measure.

For instance, the mortgage interest deduction has a profound influence on individual home-buying decisions that is so large and ingrained it's hard to imagine alternative scenarios without the deduction. Many experts contend that this tax break causes people to buy bigger homes than they could otherwise afford and encourages them to make smaller down payments and borrow more money — some of the very factors that contributed to the recent housing crash.

Some tax expenditures, such as the package of "tax extenders" that is currently stalled on Capitol Hill, routinely expire and are periodically renewed. For the past several years, the debate over the extenders has focused on whether they should be paired with revenue-raising provisions to offset their cost, but little or no attention has been accorded to their original purpose or their effectiveness at achieving their intended policy goals for the least possible cost.

Other tax expenditures are permanent features of the code, equivalent to mandatory spending that never gets reviewed and doesn't even show up as a line item in the budget.

"They get in, and most of them are on autopilot," said Scott Murphy of New York, who has joined with dozens of like-minded, fiscally conservative Blue Dog Democrats to sponsor a bill that would require the Joint Tax Committee to release an annual report on each item's "equity, efficiency and ease of administration."

Several other House Democrats have started to tackle the issue, too. Doggett has inserted language into the tax extenders bill that would require Joint Tax to study the provisions in that bill for their cost-effectiveness, unintended consequences, and the benefits and costs of continuation.

Mike Quigley, an Illinois Democrat, has introduced a bill that would set up procedural hurdles to creating tax expenditures and require routine performance reviews by CBO. As co-founder of the Transparency Caucus, Quigley also wants a better picture of who benefits from various tax breaks. "There ought to be a very transparent way to determine that and evaluate their effectiveness," he said. "It's just an extraordinary amount of money to be flying blind."

Even Boehner jumped into the discussion in a little-noticed portion of his August speech calling on Obama to fire his entire economic team. Taking particular aim at the tax extenders bill, Boehner criticized the typical way these provisions get passed.

"Are they worth it? Many are," Boehner said. "But we just go ahead and extend all of them temporarily — and usually right at the last minute — so Washington can continue pandering to the loudest voices instead of implementing the best ideas."

Taxing Politics

Economists aligned with both parties and congressional scorekeepers have often produced analyses that show problems with particular tax expenditures, but they don't write the laws. Support for the biggest items on the list is pervasive among the tax-paying public, and smaller items all have constituencies that lobby heavily for their continuation.

Those advocating a hard look at tax expenditures must also grapple with the deep anti-tax sentiment among conservatives, which has led many Republican politicians to see almost any change in tax expenditures as a “tax increase” that must be opposed.

Some conservatives, led by longtime activist Grover Norquist at Americans for Tax Reform, say they will oppose any net reduction in tax expenditures as an unacceptable addition to the overall tax burden. Norquist’s no-more-taxes pledge, routinely signed by GOP candidates eager to prove their conservative credentials, specifically includes a promise to oppose reducing or eliminating any deductions or credits, though it does allow revenue-neutral tax swaps that use base-broadening to pay for lower rates or other tax breaks.

Philosophically, the conservatives’ position stems from several related arguments. One is the corollary to the “starve the beast” theory that says tax cuts help restrain government spending by depriving it of money to grow. Under this line of thinking, trimming or eliminating tax expenditures as a way to close the budget gap simply justifies outright government spending. “The only people that bring it up are people who want a net tax increase,” said Ryan Ellis, tax policy director at Americans for Tax Reform.

Conservatives also often criticize the inclusion of preferential tax rates on capital gains and dividends as tax expenditures. The consumption tax base that many Republicans would prefer wouldn’t tax investment earnings.

A third criticism from the right rejects the entire concept of tax expenditure analysis, and contends that equating a tax cut to a spending program relies on the supposition that the government has a claim on all income and can dole it out however it wants. Those who make that argument say there is a meaningful distinction between allowing people to keep their money and having them send it to Washington and receive it back. “It’s myopic to merely look at the effect on the recipient,” Ellis said. “There’s a larger governmental effect on how the economy’s going to grow.”

Some Republican economists such as Holtz-Eakin and Feldstein, and groups such as the Tax Foundation, which favors an economically neutral tax code, criticize such arguments as shortsighted. But given the still-roiling internal debate among conservatives, getting Republicans to budge on tax expenditures may prove particularly difficult. In a more closely contested Congress, GOP support would be needed to advance significant policy changes.

Still, there are signs that a bipartisan approach to reviewing tax expenditures may be possible. In his August speech, Boehner started nudging his colleagues in that direction by simultaneously calling for spending cuts and saying that some unspecified tax expenditures are really disguised spending. Boehner spokesman Michael Steel said that after a process to determine which tax cuts were truly hidden spending programs, Boehner would support eliminating them, just as he supports cuts in discretionary spending programs.

In the current deeply partisan environment, advocates of an aggressive examination of tax expenditures are taking a multipronged approach designed to build steady and gradual support for their ideas.

First come the studies, like the ones suggested by Doggett, Quigley and Murphy. The results would help guide lawmakers toward discussion of specific tax expenditures, rather than the broad concept.

As part of this effort, the Center for American Progress has been trying to define tax expenditures in clearer terms to eliminate confusing jargon and give more ammunition to lawmakers and the public. Take, for example, the percentage depletion allowance. “When you say it like that, it sounds like a lot of gobbledygook,” said Sima Gandhi, who helped lead the tax expenditures effort at the center before joining the Treasury Department this summer. “But when I say that oil companies get a tax subsidy for drilling oil wells, it sounds a bit different.”

If definitions and studies eventually lead to action, there is some room for common ground, as Boehner suggested. The more a tax program looks like spending and the more it can be shown to be inefficient, the more likely it is that Democrats and Republicans might agree to eliminate or curtail it. Such a list, however, could very well include the refundable tax credits and grants in lieu of credits that Democrats have been adding to the tax code in recent years.

Advocates of restraining tax expenditures also are likely to try to avoid alarmist proposals, such as eliminating the mortgage interest deduction, which would draw immediate public reaction.

Instead, they will emphasize ways in which Congress might use long-term transition rules to gradually tighten existing limits or impose new ones that don't take effect immediately.

Such rules do have a downside: They give future Congresses the ability to prevent the bite from happening. "It's harder to expand something if you've completely eliminated it," says Donald Marron, director of the Tax Policy Center, a project of the Urban Institute and the Brookings institution.

However the arguments take shape, the idea of reining in tax expenditures will continue to be part of the big-picture debate about reducing the government's debt, becoming the third leg of a stool that includes spending cuts and tax increases. That mix, particularly if proposed by the bipartisan fiscal commission, just might encourage lawmakers from both sides of the aisle to step off the cliff together.

Then there's the argument from Kleinbard, who contends that an aggressive pruning of tax expenditures is the only way to avoid either imposition of a new value-added tax (VAT) or a fiscal calamity. In his estimation, the public won't tolerate deep cuts in such big-ticket programs as Social Security and Medicare, and there's not enough discretionary spending to cut to balance the books.

"If you take the view that what we're looking for are trillion-dollar solutions, ultimately, not billion-dollar solutions, you only have three levers to work with," Kleinbard said, listing higher rates, tax expenditures and a new tax such as a VAT as the only real options.

Still, even the most ardent backers of scrubbing away tax expenditures aren't optimistic about near-term action by Congress. Instead, they say, they're just trying to establish the analytical tools that will enable lawmakers to act when they're ready.

"The only thing that will force Congress to do this," says Quigley, "is when we're backed up against the wall financially."

FOR FURTHER READING: *The Wyden-Gregg bill is S 3018; the Murphy bill is HR 5291; the*

Quigley bill is
HR 5752
. State of taxation, CQ Weekly, p. 828; federal deficit, p. 274; health care and taxes, 2009 CQ Weekly, p. 2650.